United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

ORIGINAL

75-7609

To be argued by
S. Pitkin Marshall

B

P/S

In The
United States Court of Appeals
For The Second Circuit

COMPETITIVE ASSOCIATES, INC.,

Appellant,

-against-

ADVEST CO.

Appellee

On Appeal from the United States District
Court for the Southern District of New York

BRIEF FOR APPELLANT
COMPETITIVE ASSOCIATES, INC.

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ISSUES PRESENTED FOR REVIEW

1. Was the trial court in error in its conclusion that Advest was not liable under §10(b) of the Securities Exchange Act where it made cross trades to appellant with knowledge that appellant's advisor was acting on both sides of the trades?

2. Was the trial court in error in its conclusion that Advest had no liability for not supplying a prospectus to appellant?

3. Was the trial court in error in its conclusion that Advest was not liable under the Investment Advisor's Act and the Investment Company Act of 1940 where it made the aforesaid trades to appellant?

4. Was the trial court in error in certain of its fact findings and in failing completely to make findings of fact as to certain matters.

STATEMENT OF THE CASE

A. Nature of the Case.

Appellant, Competitive Associates, Inc. (hereinafter, "appellant") was at all relevant times, a California based investment company.* It has more than 1,500,000 shares outstanding, owned by the public.

In the period September, 1970, through November, 1973, Competitive Capital Corp. managed appellant (24a).** During a portion of that period, namely, from October 9, 1970, through May 14, 1971, the investment decisions (purchase and sale orders) for a portion of appellant's investment portfolio were made by Akiyoshi Yamada. Yamada's authority to make such decisions derived from an agreement dated October 9, 1970, between him, appellant and Competitive Capital Corp. (26a; 304a).

One of the stocks which Yamada purchased for appellant was a new issue called Fire Fly Enterprises, Inc. ("Fire Fly"). On its purchase and subsequent sale

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* The name of Competitive Associates, Inc., has been changed to Seaboard Leverage Fund. It is now based in New York.

** Unless otherwise noted all references are to page numbers of the appendix. All trial exhibits are included in the single appendix volume and all appendix pages are numbered consecutively at the bottom of each page followed by an "a".

of Fire Fly in early 1971, appellant lost $59,767.63. Thereafter, an investigation by appellant indicated that the market for Fire Fly stock had been manipulated by Yamada and others and that appellant had been used by Yamada as a dumping vehicle, to help artificially support the market and to "take out" stock which had been parked with Yamada's and others' nominees.

Appellant brought this action in May, 1972, against the issuer of Fire Fly, the underwriter and the several broker-dealers who had sold the stock to appellant. The suit alleged a manipulative scheme violating §15(c), §10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 ("1934 Act") and §17(a) of the Securities Act of 1933 ("1933 Act"). It also alleged that the selling broker defendants had violated §5 and §12(1) of the 1933 Act in failing to supply a prospectus to appellant and that various defendants had violated §11 and §12(2) of the 1933 Act in selling to appellant by means of material misrepresentations and omissions.

B. Course of Proceedings and Dispostion Below.

Before this case was tried, appellant had settled with most of the named defendants and the action

had been stayed as against two bankrupt defendants, Provident Securities, Inc. (the underwriter of the new issue) and Pericles Constantinou (the president of Provident). Therefore, the case was tried only as against the defendant, Advest Co. ("Advest") one of the broker-dealers which had sold Fire Fly shares to appellant.

Since the case was to be tried against only the one defendant, appellant drastically reduced and narrowed the scope of the violations it sought to prove. Rather than show what it had pleaded -- a broad based conspiracy to manipulate the public offering of Fire Fly -- appellant attempted to show very simply that Advest's and Yamada's roles in selling the stock to appellant violated the aforesaid sections of the Federal securities laws.

After several days of trial the court below took memoranda of law from both parties. Thereafter it found for the defendant, and dismissed appellant's claims against Advest with prejudice.

STATEMENT OF FACTS

In mid 1970, defendant Fire Fly made a decision to sell its common stock to the public. Fire Fly was at the time owned by a group of individuals which included one Phillip Kaye, then residing at 75 East End Avenue, New York, N.Y. Kaye was the largest single shareholder of Fire Fly, owning 77,900 shares which represented almost 20% of the entire company (23a;243a). Kaye was also a close personal friend and a business associates of Yamada. In fact, during the time of the Fire Fly public offering Kaye and Yamada shared the same office at 342 Madison Avenue, New York, N.Y. (184a).

On January 4, 1971, Fire Fly entered into an underwriting agreement with Provident Securities, Inc. ("Provident") pursuant to which Provident agreed to purchase all of the 100,000 shares of Fire Fly common stock and to offer them to the public at the initial offering price of $3.25 taking for itself an underwriter's concession of 15 cents per share (23a; 234a). At all relevant times, Pericles Constantinou was president and a director of Provident (24a).

By the middle of 1970, Yamada was in control

of several sources of investment funds in addition to the appellant Fund. He was the General Partner of Takara Partners, a limited investment partnership with assets of over four million dollars. He was a principal of Everest Management Corp. which managed the Armstrong Investors Fund, S.A., an offshore fund with assets in excess of four million dollars. And, in addition, he managed several private accounts totaling several million dollars (266a). Finally, in late 1970, Yamada began raising substantial sums of money from private investors for a second limited partnership named Seijo Associates (93a)

Using his completely discretionary authority to buy for appellant Fund, Yamada caused the following purchases to be made at stated prices at the stated times (27a):

Date	Seller	Price Per Share	Number of Shares	Total Paid
1/19/71	Chartered New England Corp.	$5-1/2	3,100	$ 17,050.00
1/19/71	Chartered New England Corp.	5-5/8	2,900	16,312.50
2/ 1/71	Chartered New England Corp.	5-3/4	3,000	17,250.00
2/ 2/71	Sherwood Securities Corp.	5-3/4	3,000	17,250.00

Date	Seller	Price Per Share	Number of Shares	Total Paid
4/ 2/71	Newburger (Advest)	$6-3/4	4,350	$ 29,362.50
*4/26/71	Sherwood Securities Corp.	6-3/8	4,000	25,500.00
4/28/71	Sherwood Securities Corp.	6-1/2	2,650	17,225.00
5/ 5/71	Snerwood Securities Corp.	6-1/2	10	65.00
			23,010	$140,015.00

As to each trade, Yamada instructed appellant's trader, Clifford McSwain, as to the number of shares to be bought and the price to be paid. Yamada also designated the broker from whom each of the purchases should be made (27a).

At a meeting of the appellant's directors on May 13, 1971, for reasons not directly related to his role in the public issue of Fire Fly, (it was discovered that Yamada had lied to the board in his appearance before it on January 13, 1971) it was unanimously decided that Yamada should be fired as Portfolio Manager (342a). On May 12, 1971, as part of the two-day meeting of the board, the directors had reviewed Yamada's portfolio. At that time, they discovered that he had caused the

* Defendants would not stipulate in the Pre-Trial Order that plaintiff had made this purchase because no buy ticket could be found at that time. Subsequently, however, the ticket was found and was admitted herein as part of plaintiff's Exhibit 18.

plaintiff to purchase 23,010 shares of Fire Fly, a thinly traded, speculative stock which none of the directors had ever heard of. Thereupon, the board directed that all of the stocks in Yamada's portfolio be thoroughly reviewed and investigated and that Fire Fly specifically (along with another stock called Fantastic Fudge) be sold as soon as possible (342a-343a).

Thereafter, on May 19, 1971, the plaintiff sold all of its 23,010 shares of Fire Fly at a price of $3-1/2 per share for a total of $80,535. After subtracting tax costs of $287.63, the plaintiff's sale of Fire Fly yielded net proceeds of $80,247.37. Since $140,015.00 had been paid for these shares, the plaintiff suffered a loss of $59,767.63 (27a).

ADVEST AND
PETER ENGELBACH

From March of 1971 to June of 1971, Peter Engelbach was employed as a registered representative at Advest in Philadelphia (64a). Prior to that time, since June, 1970, Engelbach had been employed in a similar capacity at Woodcock, Cummings, Taylor and French ("Woodcock") also in Philadelphia (63a). Engelbach had met Yamada in 1965 when they both were employed at Kuhn, Loeb & Company in New York (65a). Subsequently, Engel-

bach and Yamada became close friends, roommates and business associates (129a-133a). Engelbach and members of his family purchased one unit for an investment of $100,000 in Yamada's hedge fund, Takara Partners (90a).

Yamada also supplied Engelbach with certain retail accounts which were controlled by Yamada in that Yamada had discretionary authority over purchases and sales which they made (93a; 99a-102a). Among these accounts were Jack and Rose Shaw, Hyman Escava, Bill Davis and, of course, the plaintiff (99a-102a). In addition, Yamada was the investment advisor for the account of Jacob Blumenthal. Finally, Engelbach had other customers who followed Yamada's "coat tails" without actually retaining him as an advisor (104a). Each of the customers named above (except the plaintiff) had invested substantial sums of money in either or both of Yamada's other investment vehicles, Takara Partners and Seijo Associates. Davis had put $100,000 in Takara (44a) and subsequently put $50,000 in Seijo. Escava (through M. H. Company) had put $100,000 in Takara. The Shaws invested $200,000 (later reduced to $100,000) in Takara and $50,000 in Seijo (197a-198a; 206a). Blumenthal invested in Seijo (94a).

Although the investments were made in Takara Partners when it was originally organized in June of 1969 (91a), Yamada and to some extent, Engelbach, continually solicited his customers for more investment funds. Yamada initially agreed with Davis that if he could double Davis' $50,000 of private investment money, the entire $100,000 proceeds would be used to make a further investment in Takara Partners (48a). In October 1970, Yamada wrote Davis soliciting money for Seijo and indicating that an investment should be made in Seijo by notifying Engelbach who would arrange to withdraw the funds from Davis' account. Later Yamada convinced Davis to invest $50,000 in Seijo even though he had not doubled Davis' private investment funds (48a). Engelbach successfully solicited funds for Takara from Blumenthal (91a) and, apparently unsuccessfully, solicited from other people in Philadelphia (92a). Both Yamada and Engelbach solicited investments for Seijo (93a) and Yamada wrote to Shaw in September 1970 asking for further investment in Seijo (254a). Thereafter, Yamada convinced Shaw to buy a $50,000 share of Seijo by giving him a discount to make up for earlier losses in Shaw's purchase of Monarch Industries (206a).

On January 4, 1971, the Fire Fly public offering of 100,000 shares went effective at an initial offering price of $3.25 per share (23a; 234a). Both Pericles Constantinou and Yamada urged Engelbach to buy Fire Fly stock for his customers (108a; 112a). Engelbach was at Woodcock when the Fire Fly offering went effective. Woodcock refused to participate in the offering as a selling group member. They did not like Constantinou's firm because they thought it was to small (110a). Since Yamada insisted that his discretionary accounts buy Fire Fly, two steps were taken. First, accounts were opened in the names of Yamada's nominees at Chartered New England Corp. (114a). Second, Engelbach bought for the nominees through Woodcock in the aftermarket (109a).

At Chartered the following accounts among others purchased Fire Fly in the offering at 3-1/4 per share (216a-220a):

Jacob Blumenthal	1,000
Jack Shaw	500
William Davis	500
James Hudson	3,000
Martin Wiener	200
Simon Kaplowitz	100

Of these people, Blumenthal, Shaw, Davis and Hudson were all accounts controlled by Yamada. Elgin Cary, the registered representative at Chartered who received commissions on these sales testified that he had no recollection at all of ever having known or spoken to or done any business of any kind with Blumenthal or Kaplowitz (T89,80).* He did, however, recollect specific conversations with Davis and Shaw as to their purchases of Fire Fly (T30, 85). Yet both Davis and Shaw are sure that they never met or talked with Cary, that they never opened brokerage accounts at Chartered and they were not aware of having purchased Fire Fly at Chartered (42a; 53a; 212a-213a). Cary further testified that Hudson and Wiener were referred to him by Constantinou, but that he never inquired of them or of Constantinou why they did not buy their stock directly from Provident (T28-29; T77; T91). Cary also swore that Hudson never mentioned Yamada to him (T91), and that Hudson did mention Yamada to him (T45). In short, Cary's testimony was entirely incredible. One conclusion is clear, however: Cary was simply handed or given all of his Fire Fly customers by Constantinou and/or Yamada.

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* References marked "T" are to parts of the trial transcript which were not included in the Appendix.

He was given approximately $600 in commissions in one day of trading for accounts which were not really his (220a).

Paul Tessler, the registered representative at Chartered who handled all of the other accounts which bought in the underwriting and who earned approximately $1,200 commissions in one day has refused to testify as to Fire Fly on the grounds that his answers might incriminate him (220a; Pl.Ex. 23).*

In addition to the Fire Fly shares purchased by Yamada-controled accounts as outlined above, the following purchases were made through Engelbach when he was at Woodcock (222a; 256a; 225a; 226a; 71a):

William Davis	700 shares
Hyman Escava	100 shares
Rose Shaw	900 shares

By April 2, 1971, Engelbach's customers, including Yamada "coat tail" followers as well as Yamada nominees, owned a total of 6,350 shares of Fire Fly. Of this amount, 4,350 shares were sold to appellant on that date at Yamada's instruction (257a-258a).

YAMADA'S AND ENGELBACH'S BREACH OF FIDUCIARY DUTY AND FRAUD

Engelbach knew as early as October 1970 what

* Plaintiff's Exhibit No. 23. Not included in appendix.

sort of an entity appellant was and that Yamada was the Portfolio Manager for plaintiff (84a). He also knew that Yamada controlled the Shaws' accounts, Davis' account, Escava's account, that he advised Blumenthal, and that other Engelbach customers were Yamada "coat tail" followers (102a-104a). Engelbach pretends that he specifically contacted each of these customers to get their approval each time a buy or sell was recommended by Yamada (69a-71a). He also pretends that the customers exercised some discretion themselves, at least as to sells (102a). Both Shaw and Davis contradicted Engelbach on these points. Both were entirely sure that Yamada and Engelbach made both purchases and sales in their accounts and only informed them after the fact, either in occasional telephone conversations or by their receipt of confirmations of the transactions which had taken place (48a; 56a; 208a;210a-211a). For purposes of plaintiff's claims against Advest, it should make little difference except as to Engelbach's credibility and as to his state of knowledge of what Yamada was actually doing. The point is that Yamada and Engelbach were "crossing" trades between Yamada's controlled accounts.

Engelbach had knowledge of more than the mere cross-trading. He knew that Yamada's nominees all had

substantial investments in Takara Partners and/or Seijo (references above). He knew that Yamada repeatedly solicited further investments in hi nvestment partnerships. Indeed, he himself assisted Yamada in these efforts (references above). There can be no doubt that Yamada had a substantial personal interest in making profits in his nominees' private protfolios. There can be no doubt that Engelbach knew of Yamada's personal interest. For example, if Yamada could double Davis' $50,000 of private funds, Davis would invest an additional $100,000 in Takara Partners (48a). Yamada had guaranteed verbally and in writing that he would make up losses incurred by Shaw in his purchase of Monarch (207a; 254a). Engelbach knew of this promise (121a).

In summary, what Yamada was doing was forming and marketing limited partnership shares for his personally run investment vehicles. Engelbach was actively assisting him. One of the chief mechanisms used to market the limited partnerships was to form private brokerage accounts for Yamada's potential investors and to general profits in those accounts as an inducement to further investment in Takara Partners or Seijo. Yamada insisted that the private accounts must be handled

by Engelbach. In Shaw's case, Yamada specifically refused to handle the private funds except through Engelbach even over Shaw's remonstrances and even though Shaw's son was a broker and needed the business (201a). The final ploy in Yamada's scheme -- and what made it all effective -- was to use the plaintiff as a dumping ground for the stocks used to generate the profits for private investors.

Engelbach pretends not to see the legal and ethical conflict which he and Yamada were involved in. In practical terms, however, the conflict is inescapable and came out clearly in Engelbach's own testimony. At first Engelbach testified that he quite probably informed all of his customers that Yamada recommended sale of Fire Fly on April 2, 1971 (73a). He further testified, however, that he did not tell the sellers they were selling to a Yamada controlled entity (119a). Finally, he himself blurted out the crux of the problem and the basis for plaintiff's claim. When asked if he advised DAvis that Yamada thought it was an appropriate time to sell, he said (115a-116a):

> "I don't recall that I did say that Yamada said it was an appropriate time to sell. If anything, I may have said to him that there was a buyer around,

> was he interested in selling. I don't recall that I said to any of these people Yamada said they should sell. That doesn't make sense. Yamada is advising the fund to buy the stock. Why should he, on the other hand, be advising other people to sell their stock? He left the decision whether they want to sell the stock up to them."

This is all true except for the last sentence. There is ample testimony that Yamada's nominees exercised little, if any, control over their own accounts. In any case, even the sellers could not possibly have made an informed decision on whether to sell without full disclosure from Engelbach that Yamada was also the buyer. This non-disclosure on both sides is the very essence of illegal cross-trading.

Whatever he may have told the sellers, there is no doubt that neither Engelbach nor anyone else at Advest made any disclosures at all to the appellant (78a; 80a-81a). This alone constitutes a violation of §10(b), Rule 10b-5 and §15(c) of the Securities Exchange Act of 1934, of §17(a) and §12(2) of the Securities Act of 1933, of §206 of the Investment Advisors Act of 1940, and of §17 of the Investment Company Act of 1940.

POINT I

THE TRIAL COURT ERRED IN FINDING NO LIABILITY OF ADVEST UNDER §10(b), RULE 10b-5 AND §15(c) OF THE 1934 ACT*

A. The scienter requirement.

The court below found that Advest had no liability under the anti-fraud sections of the securities laws. This conclusion seems to have been based entirely on the court's view that Engelbach was not a bad guy. The court made no attempt at all to deal with the concepts of materiality or scienter as they are applied in cases under §10(b) and Rule 10b-5 of the 1934 Act. Rather the court stated its view that "Engelbach's role has not been shown to be sinister in this transaction," and that, "For all this record reveals, Engelbach had no reason to suspect anything untoward in Yamada's seeking Firefly stock through him . . . for sale to Competitive."

Appellant submits that questions of whether a

* This point treats §17(a) of the 1933 Act concurrently, the only significant difference being that that statute gives a right of action only to a purchaser which appellant here is.

person's role is "sinister" or whether his acts are "untoward" are not the proper tests of a §10(b) cause of action. The court below cited no authority at all for its holding. It made no attempt to distinguish cases cited in plaintiff's post-trial memorandum.

The trial court states at page 12 of its opinion that Engelbach and Competitive were "duped" by Yamada and that for a fraud claim to prevail, "plaintiff would have to show that Engelbach had knowledge or with knowledge participated in the fraud." (376a) But there are no findings at all as to what knowledge Engelbach did have and as to what precise knowledge he would have to have to sustain a fraud claim.

Yet the record in the case does not prove anything against Yamada that it does not also prove against Engelbach. There is no doubt that Engelbach had knowledge of at least the following:

1. That Yamada had complete discretion over the accounts of Shaw, Davis and others.

2. That those private nominees of Yamada had already invested funds in vehicles controlled by Yamada.

3. That Yamada and Engelbach were both continually soliciting Yamada's nominees and others to invest more funds in Yamada's vehicles (either Takara or Seijo or both).

4. That Yamada had guaranteed profits to at least one of his nominees (Shaw).

5. That if Yamada could double one private account (Davis) the entire proceeds would be invested in Takara.

6. That Engelbach stood to benefit not only from all the trading activity Yamada sent him but by increased investments in Takara in which Engelbach was a participant.

7. That Fire Fly was a speculative "high flyer" (to say the best possible things about the stock) which his firm (Woodcock) would not touch in the original issue and which Yamada was recommending -- nay, insisting upon -- for his nominees, even to the extreme of opening up new accounts for them at Chartered so they could buy in the offering.

8. That Yamada was crossing trades among

his controlled accounts in such a way that he was effectively buying out his private nominees' holdings by the use of his fund, Competitive.

9. That he was not supplying a prospectus to Competitive with its purchase of Fire Fly.

Section 10(b) of the Exchange Act makes it unlawful to use or employ in connection with the purchase or sale of any security any manipulative or deceptive device or contrivance in contravention of such rules as the Commission may prescribe. Rule 10b-5 makes it unlawful to employ any device scheme or artifice to defraud, to make an untrue statement or omit to state a material fact or to engage in any act, practice or course of business which would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security. Section 15(c) of the Exchange Act specifically applies to broker-dealers and prohibits essentially the same conduct as does §10.

It is well established in this Circuit that in order to satisfy the scienter requirement of a 10b-5 claim it is not necessary to prove evil motive

or intent to defraud. Nor we submit, should it be necessary to prove a "sinister role" or knowledge of "untoward actions."

There are several recent cases in this Circuit discussing the scienter standard. They are well summarized in Republic Technology Fund, Inc. v. Lionel Corp., 483 F.2d 540 (2d Cir. 1973):

> "The test to be applied is clear in terms, not in application. As explicated most recently in the opinions of Judge Timbers and Judge Mansfield in Chris Craft Industries, Inc., supra., slip op. at 362 (Timbers, J.) and at 396 (Mansfield, J.), something short of specific intent to defraud is required and something more than "mere" negligence; certainly, knowledge of the fact that the figures created a false picture is enough, and on the part of sophisticated corporate managers a reckless disregard of the truth is sufficient." (citations omitted).

See also, Shapiro v. Merrill, Lynch, Pierce, Fenner & Smith, 495 F.2d 228, (2d Cir. 1974); Cohen v. Franchard Corp., 478 F.2d 115, 123 (2d Cir. 1973); Globus v. Law Research Service, Inc., 418 F.2d 1276, 1291 (2d Cir. 1969) cert. denied 397 U.S. 913 (1970).

In this action it is clear that Englebach had much more than the modest amount of knowledge required as scienter. He was, in fact, a participant in all of the matters which should have been disclosed to appelant.

B. The Materiality of the Cross trading by Yamada and Engelbach.

Appellant contends that certain of the trial court's findings of fact were clearly erroneous. That subject will be treated in a later point. Nevertheless,

even on the basis of Judge Carter's fact findings, Advest's failure to disclose its cross trading should subject it to liability under §10(b).

This case is certainly no less than a classic Affiliated Ute situation. In Affiliated Ute Citizens v. U. S., 406 U. S. 128 (1972) the Supreme Court set the standards for application of Rule 10b-5 in non-disclosure situations. There, two employees of a transfer agent bank failed to disclose to certain sellers of securities that they had an interest in the securities and that they were actively encouraging a market in the securities.

The Supreme Court noted and cited authority for the proposition that Congress intended anti-fraud securities legislation to be construed, "not technically and restrictively but flexibly to effectuate its remedial purposes." SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963); Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6 (1971). The Court went on to hold the employees liable for not disclosing to the sellers "material facts that reasonably could have been expected

to influence their decisions to sell." The Court then said at p. 153:

> "It is no answer to urge that, as to some of the petitioners, these defendants may have made no positive representation or recommendation. The defendants may not stand mute while they facilitate the mixed-bloods' sales to those seeking to profit in the non-Indian market the defendants had developed and encouraged and with which they were fully familiar."

In the present case, it is not a matter of the trial court's construing the anti-fraud statutes too restrictively; rather, they were not construed at all. The narrow question should be, not whether Engelbach's role was "sinister", but whether his activities and his non-disclosure of them amount to a violation of Rule 10b-5 under Affiliated Ute and other applicable precendent.

A case squarely in point is William I. Hay, 19 S.E.C. 397, 45-47 CCH ¶75,550 (1945). The "Yamada" in that case, an investment advisor named Page, held discretionary authority over a number of accounts and effected transactions for them at respondent, brokerage house. Page initiated the transactions which were executed by the firm as broker; the firm confirmed the trades directly to the customers, sent them monthly

statements and took commissions (which were not shared with Page). The questions raised were whether the firm should have disclosed to Page's customers (1) the condition of the companies where Page was investing their trading profits and (2) the material facts of the transactions in which securities were cross-traded between Page's clients. The Commission held that such disclosures were necessary and that failure to make them subjected the firm to liability under §10(b) and 15(c) of the Exchange Act.

The Commission's discussion of the broker's responsibilities is directly relevant to the present case. The Commission states at 19 S.E.C. 405:

> "Respondents' major defense to all the allegations is that they owed no direct duty of disclosure to any of Page's clients. They claim that since Page had discretionary power to deal with his clients' accounts they were fully authorized to accept his orders and insulated from any direct brokerage duties except to Page."

To this the following footnote is added:

> "Although Page claimed that he procured specific authorizations for transactions effected for accounts over which he did not have discretionary power, these authorizations were not transmitted to respondents. In effect they obeyed Page's instructions as to transactions and withdrawals of funds in many cases in which

> they had on file neither powers of attorney nor specific authorizations. We think it clear that such conduct was at best extremely negligent and created a great risk of harm to customers."

(The same lack of written authority exists in the present case) The Commission's consclusions are stated in part at 19 S.E.C. 406:

> "The facts basic to respondents' defense are not in dispute. However we cannot conclude that respondents owed no duty of disclosure to Page's clients. Whatever might be the result if respondents had no knowledge of the facts which rendered Page's transactions improper, this is not such a case. Here the facts which imbued all of the transactions with fraud were apparent and known to the respondents."
>
> "Page was known to be President of both of the speculative and promotional ventures in which he placed clients' money. His success was bound up with the success of the security selling program; his very salary depended on his ability to sell securities. Every direction to purchase Metoloy or General Minerals securities for a client's account was an act of double-dealing apparent on its face. Respondents knew intimately of many of the details of this conduct, from Hay's directorship, from their continuous and close contact with Page and from their handling of all of the transactions. Had they been sensitive to the impact of this conduct and to their duties they would have stopped execution of all transactions until they were sure that Page had authority to engage in conduct fraudulent on its face. By continuing with the executions of Page's orders, knowing what they knew, they participated in and made themselves part of his scheme. To avoid individual responsibility for his fraud they were obligated to make the fullest disclosure directly to the customers."

"Page's clients were customers of respondents, and, as we have noted, the firm as a broker, confirmed many of the transactions directly to Page's clients and sent them regular statements of account. For these confirmations to be truthful they whould have been accompanied by full disclosure."

***

"The result was that the customers were utterly without protection -- served by two agents, one with discretionary power over their accounts acting faithlessly and the other a broker, knowing of the faithlessness yet claiming to be free of any duties." (p.407)

This summary could be word-for-word a characterization of the state of knowledge and of the acts of Engelbach. In both cases, the undisclosed material concerned (1) the obvious self interest of the advisor in the profits of his accounts and (2) the cross trading activities which allowed those profits to be generated. In the present case Engelbach's knowledge was, if anything, greater and his implication in the cross trading was more direct. He knew exactly what Yamada was doing for the nominee accounts and he knew why. Since he himself was assisting in the fund raising activities, he had a personal interest in prevent-disclosure to appellant of the cross trading and its purpose of raising money for Seijo and Takara, private deals in which Englebach was a co-venturer with Yamada.

A related case is Oxford Company, Inc., 21 S.E.C. 681, 45-47 Fed. Sec. L. Rep. ¶75,609 (1946). There, the respondent broker effected cross transactions between customer accounts over which it had discretion. It interposed itself as principal in the transactions and did not disclose to its customers that the trades were crossed and that it was making a profit in the middle. The Commission held that these practices constituted willful violations of §17(a) of the Securities Act and of §§10(b) and 15(c) of the Exchange Act. The scheme in Oxford was ridiculously simple compared to what Yamada and Engelbach did, but the effects were similar and the duty to disclose is present in either case. In Oxford, the Commission said at 21 S.E.C. 689:

> "This secret profit aggregated $1,321.68 on the two cross-transactions. All transactions were confirmed with the use of principal confirmations. In this series of transactions respondent clearly failed to perform its duties as broker -- not to trade for its own account without express and informed authorization, to secure the best possible prices for its principals in sales and purchases, to confirm as agent, and to divulge all profits obtained by it."

In the Fire Fly transactions the profits were greater and the scheme a little more complex. The nominee

accounts profited; Engelbach profited by brokerage commissions on each of the several steps of the transactions; Woodcock profited; Advest took its 1/8 mark up on the sale as principal; Yamada proved to his private investors, yet again, that he was an investment genius and therefore entitled to increased investments in Takara and Seijo. Only the appellant, who was not told what was going on, lost.

The trial court recognized, in part, the insidious nature of the cross trading. Not only did it find that Yamada had "duped" Competitive; but it found, most remarkably, that <u>Yamada's private nominee accounts could make a 10b-5 claim against Engelbach for not disclosing that Yamada acted on both sides of the trades</u> (375a). Appellant respectfully submits that this conclusion, probably correct (if the private accounts had sustained damages), is blatantly inconsistent with the trial court's conclusion that appellant <u>does</u> <u>not</u> have a cause of action for precisely the same fraudulent activity -- non-disclosure that Yamada acted on both sides.

Engelbach's testimony made it quite clear that he did not disclose to either side of the trades the fact that Yamada was acting for both, and the additional fact that Yamada (and Engelbach, to a lesser extent) had a personal economic motive for creating over-night profits for the accounts who were selling to plaintiff. He was also

careful not to make this disclosure to his superiors at Advest although he seems comfortable with his testimony that Switsky and Weintraub gave their approval to his trade. The point is that the cross trading cannot be legitimized in any way by the approval of En bach's superiors. Engelbach failed to disclose to them the same crucial information that he withheld from appellant.

Advest cannot escape its disclosure responsibilities by claiming that it acted as principal. Rule 15cl-4 of the Exchange Act provides that where a broker is acting as broker for another customer or for both parties, it must disclose the name of the other party and the price and date of the corresponding trade. In Norris & Hirshberg, Inc., 21 S.E.C. 865; CCH Fed. Sec. L. Rep. ¶75,621 (1946) the Commission holds that a broker cannot avoid this requirement by interposing itself as a principal in a cross trading transaction (see 21 S.E.C. 886-889). In the present case, in effect, Advest acted as broker or agent for both the Yamada controlled sellers and the Yamada controlled buyer. It had specific duty under Rule 15cl-4 (in addition to the general obligations imposed by all of

the anti-fraud statutes) to disclose that fact along with the other parties' names and Yamada's role to both sides of the transaction. That duty cannot be avoided by its choosing to act as principal.

The application of the anti-fraud sections of the securities laws to broker-dealers as stated by the Securities and Exchange Commission in the foregoing cases has been equally well established in this District and in this Circuit. In Opper v. Hancock Securities Corporation, 250 F.Supp. 668 (SDNY 1966), aff'd 367 F.2d 157 (2d Cir. 1966) this Court held a broker liable under the anti-fraud sections for selling out its own stocks in preference to those of its customer while representing to the customer that it was continually seeking a purchaser for his shares. The Court found that the broker had a fiduciary duty to the customer which had been breached. It also said (as in Norris & Hirshberg, Inc., supra) that this fiduciary obligation could not be avoided simply because the broker dealt with its customer as principal rather than as agent.

C. Causation.

In order to show that Engelbach's acts

constituted fraud, plaintiff will have to prove one additional element: "causation-in-fact" (often referred to as or confused with the element of "reliance").

Since the §10b and 15(c) claims in this action are based primarily upon material non-disclosures it is unnecessary and inappropriate to deal with the element of "reliance." If that concept has any life left, it is in affirmative misrepresentation cases.

In Chasins v. Smith, Barney & Co., 438 F.2d 1167 (2d Cir. 1970), a case under §10b wherein liability was found for failure of the defendant to disclose that it was a "market maker", the Court stated the causation standard:

> To the extent that reliance is necessary for a finding of a 10b-5 violation in a non-disclosure case such as this, the test is properly one of tort "causation-in-fact". Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787 (2d Cir. 1969). (p. 1172)

To the same effect are Affiliated Ute Citizens v. U.S., 406 U.S. 128 (1972) and Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974). In the latter, the Court enlarges upon the causation-in-fact standard:

"While the concepts of reliance and causation have been used interchangeable in the context of a Rule 10b-5 claim, the proper test to determine whether causation-in-fact has been established in a non-disclosure case is "whether the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the undisclosed fact."

In order to recover, the plaintiff need only show that its damage resulted from or was in fact caused by the material non-disclosures of the selling broker. If Engelbach had disclosed to plainti... ..hat at Engelbach's brokerage firm Yamada maintained a string of informally discretionary, private accounts, which he managed and advised; that he and Yamada actively were attempting to raise private investment funds from these accounts, i.e., to sell them interests in private "hedge funds" run by Yamada; that these accounts were the sellers in the Fire Fly transactions in which plaintiff was the ..yer; that these accounts were making profits on the transactions; that he (Engelbach) had a dual role, as Yamada's agent and as broker for the plaintiff; or that he and Yamada had a personal interest in the success of the private customers' portfolios, then the sales certainly would not have taken place to say the least.

POINT II

THE TRIAL COURT ERRED IN FINDING NO LIABILITY OF ADVEST UNDER §5(b)(1) AND §5(b)(2) OF THE 1933 ACT

Advest admits that it did not send a Fire Fly prospectus to plaintiff along with the confirmation of the sale (Pl. Ex. 25, p.4)*. For such failure Advest should be held to strict liability under §5(b)(2) for delivering securities which are not accompanied or preceded by a prospectus and under §5(b)(1) for delivering a confirmation (which amounts to a prospectus) which does not meet the requirements of §10 of the 1933 Act.

The court below held that Advest had not violated §5 for three reasons: First because such liability "would hardly make sense and would be grossly unjust" (372a). Second, because Engelbach and Advest were entitled to assume that appellant already had a copy of the Fire Fly prospectus (373a). Third, because the claim is time barred (373a).

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* Plaintiff's Exhibit 25, page 4. Not included in Appendix.

The trial court's first two findings are erroneous in several ways. In the first place, liability (under §12(1)) for violation of §5 is virtually absolute. There is no defense of "unjustness" or that the result would have to "make sense". Similarly, it should be no defense for the seller who violates §5 that the purchaser's investment advisor had a copy of the prospectus.

The trial court cites no authority for its finding that Yamada's possession of a prospectus relieves Advest of its §5 obligation. First, it must be noted that there was no competent proof at trial that Yamada did have a prospectus. Engelbach testified only that Yamada had sent <u>him</u> a prospectus. There was no indication of the date when it was supposedly sent. There was no indication whether Yamada sent it himself or caused someone else to send it. There was no indication of whether it was a preliminary or a final prospectus. (Professor Loss says that only a <u>final</u> prospectus will satisfy §5(b). 1 <u>Loss</u>, <u>Securities Regulation</u> 246 (2d Ed. 1961)).

Second, Yamada was not the purchaser of the Fire Fly stock. He was not even an employee of appellant. He was merely an independent contractor with

authority to instruct the Fund's traders what to buy and sell (304a). Confirmations of sale were not sent to him. The stock certificates themselves were not sent to him. He had no express or apparent authority of any kind to receive prospectuses for appellant for purposes of §5. Yamada, in fact, was one of the co-conspirators who kept Fire Fly prospectuses out of the hands of appellant.

Third, even if Yamada's possession of a prospectus could relieve Advest from liability under §5(b)(2) (which appellant submits is clear error) Advest is still liable under §5(b)(1) for sending a confirmation to appellant which does not meet the requirements of §10 of the 1933 Act. The term prospectus is defined broadly in the 1933 Act to include within its meaning an ordinary confirmation; and since the confirmation sent to appellant is not itself a formal prospectus, it must be accompanied or preceded by a prospectus. Securities Act Release No. 2623 (July 25, 1941).

Finally, §5(b)(1) has been interpreted to require that not just anyone but the actual seller of the subject securities must supply a prospectus which accompanies a confirmation. Therefore Advest is liable under that section even if Yamada had received a

prospectus from other sources. Securities Act Release No. 2623, Question and Answer #3, page 4 (July 25, 1941); Securities Act Release No. 828 (June 4, 1936).

The court below found that appellant's §5 claim was barred by the one year statute of limitations contained in §13 of the 1933 Act. Several points should be made in brief:

First, Advest did not put in any testimony or evidence at all to show that plaintiff could have or should have discovered the fraud earlier.

Second, in its findings, the trial court has completely missed the point of why a prospectus is required by §5. The court states that appellant "knew, or should have known, when it received the 4,350 Fire Fly shares from Advest in April that a Fire Fly prospectus had not been supplied." (374a). The point is, that without receiving a prospectus, appellant had no idea what Yamada was buying for it. It had no idea that it was buying a new issue, or that a prospectus was required, or how much of the new issue it was buying, or just how bad the stock really was.

Third, in a related case (Competitive Associates, Inc. v. International Health Sciences, Inc., et al., 1975 CCH Fed. Sec. L. Rep. ¶94,966) which was also

instituted on May 4, 1972, where this same plaintiff's agents were examined and cross-examined and a full record was made as to plaintiff's knowledge and supervision of Yamada, Judge Brieant found specifically that the plaintiff could not reasonably be held to have discovered the fraud committed until approximately 30 days after Yamada was fired, or approximately June 14, 1971. The Court reviewed the evidence as to rumors about Yamada and the board of directors meeting of January 13, 1971 and then made the following findings at p. 97,338:

> "Even when, finally, Yamada was discharged by the Board of Directors for lying, this fact did not immediately place the Directors on notice of the claimed scheme in this case. It would be foolhardy to suggest that, having established Yamada was a crook, and that he had fleeced the Fund in connection with Fantastic Fudge or Fire Fly Enterprises, as he apparently did, a reasonable Director must immediately infer that all investments of the trust funds made by Yamada were fraudulent. What is clear today was not necessarily clear in early 1971. The Fund discharged Yamada on May 14, 1971, and in the Court's view under the circumstances of this case, was entitled to at least a 30-day period thereafter as a reasonable time within which to investigate and ascertain the facts concerning the IHS issue, some of which remain unclear even to this day. This action was brought

> on May 4, 1972. To require knowledge at a prior date necessitates judging the actions of the Directors "in the light of such subsequent events as could not, through compliance with their duty, have been anticipated. A wisdom developed after an event, and having it and its consequences as a source, is a standard no man should be judged by." Costello v. Costello, 209 N.Y. 252,262 (1913).

The §13 Statute of Limitations as to plaintiff's §5(b)(2) claim should be applied similarly to that applicable to §12(2): that is, the statute should run from the time when the non-delivery of a prospectus could reasonably have been discovered. It is settled law that fraudulent concealment of the §5 violation will toll the otherwise absolute time limit of §13. Katz v. Amos Treat & Co., 411 F.2d 1046, 1054 (2d Cir. 1969); Competitive Associates, Inc. v. Fantastic Fudge, Inc., 58 F.R.D. 121, 124 (S.D.N.Y. 1973). In this case it was Engelbach who had knowledge of and who participated in Yamada's cross trading, and it was Engelbach who had knowledge of and who participated in Yamada's fund raising efforts with respect to his nominee private accounts. It was also Engelbach who was responsible for making full disclosure of all of these matters to plaintiff. Certainly a minimum requisite disclosure was delivery of a

prospectus in compliance with §5(b). Under these facts it must be held that Engelbach's own knowledge and participation in the fraud on plaintiff is sufficient to toll the period of limitations under §13.

POINT III

YAMADA VIOLATED §17 OF THE INVESTMENT COMPANY ACT OF 1940 AND RULE 17d-1 THEREUNDER; ADVEST AIDED AND ABETTED SUCH VIOLATION

A. Violation of §17(d).

Rule 17d-1 under the Investment Company Act of 1940 ("1940 Act") makes it unlawful for affiliated persons of registered investment companies to engage in transactions in which the investment company is a joint or joint and several participant unless prior to the transaction an application has been filed with and order entered by the Securities and Exchange Commission granting the application. Clearly, Yamada was an affiliated person of appellant, a registered investment company, pursuant to the provisions of §2(a)(3) of the 1940 Act.

Each of Advest's sales of Fire Fly stock acquired from Yamada nominees pursuant to the arrangement established by Yamada constituted individual violations of Rule 17d-1 and the entire arrangement involving Yamada's use of appellant as a dumping ground

also violated Rule 17d-1. See for example the definition of an "arrangement" within that Rule under similar facts in S.E.C. v. Talley Industries, 399 F.2d 396 (2d Cir. 1968) cert. denied, 393 U.S. 1015 (1969); S.E.C. v. Midwest Technical Development Corp., CCH Fed. Sec. L. Rep. ¶91,252 (D. Minn. 1963); S.E.C. v. Fifth Avenue Coach Lines, 289 F.Supp. 3 (S.D.N.Y. 1968).

B. Violation of §17(a).

The nominee accounts were "affiliated persons" of Yamada by definition of §2(a)(3) of the 1940 Act. As such they were prohibited by §17(a) of the 1940 Act from selling their Fire Fly shares directly to appellant. S.E.C. v. Fifth Avenue Coach Lines, supra. By selling through Advest, the nominees cannot avoid their violation of §17(a). The 1940 Act anticipates such an end run around the protection of §17(a). It provides as follows in §48(a):

> "It shall be unlawful for any person, directly or indirectly, to cause to be done any act or thing through or by means of any other person which it would be unlawful for such person to do under the provisions of this title or any rule, regulation, or order thereunder."

C. Violation of §17(e).

Yamada received compensation for his cross trading of Fire Fly in the form of increased participation by his private nominees in Seijo and Takara Partners. Whether increased investments were made as a direct result of the profits generated for the nominees in Fire Fly is not crucial. The point is that Yamada was personally interested in the sell side of the cross trades. Such a self interest of an investment advisor violates the anti-kickback provision of the 1940 Act, §17(e). U. S. v. Deutsch, 451 F.2d 98 (2d Cir. 1971).

D. Advest is liable as an aider and abettor of all of the above violations of §17.

Advest, through Engelbach, was aware of Yamada's arrangement to channel the Fire Fly shares from the nominee accounts, through Advest to appellant. Thus Advest satisfies each of the requisite elements necessary for the imposition of §17 liability on an aider and abettor. These elements are set forth as follows in Landy v. F.D.I.C., 486 F.2d 139, 162, cert. denied, 416 U.S. 960 (1974):

"(1) that an independent wrong exist; (2) that an aider and abettor know of that wrong's existence; and (3) that substantial assistance be given in effecting that wrong." (citing the requirements of Section 876(b) Restatement of Torts.)

In this case there is no need to discuss the first and third elements; an independent wrong existed and the transactions could not have been completed without Advest's substantial assistance. The latter point distinguishes this case from Landy where the case against the brokers was dismissed because there was no showing of substantial assistance.

The knowledge requirement is satisfied where the defendant either knew about the violation or had a duty to know. Hochfelder v. Ernst & Ernst, 503 F.2d 1100, 1104 (7th Cir. 1974); cert. granted, 421 U.S. 909 (April 4, 1975). There the court found that a claim as an aider and abettor can be maintained by showing:

"that the party charged with aiding and abetting had knowledge of or but for a breach of duty of inquiry, should have had knowledge of the fraud, and that possessing such knowledge the party failed to act due to an improper motive or breach of a duty of disclosure."

Here as in Hochfelder there was a duty of

inquiry imposed by New York Stock Exchange Rule 405 requiring member brokers to use due diligence in learning the essential facts relative to each customer, order or account. Moreover the court below already found that Advest had sufficient personal involvement by controlling and representative employees, excluding Engelbach, to be held liable if any liability by virtue of the transaction is established (375a).

POINT IV

ADVEST IS LIABLE UNDER §206 OF THE INVESTMENT ADVISERS ACT OF 1940

Appellant claimed below that Engelbach's acts subjected Advest to liability under §206 of the Investment Advisers Act of 1940. The trial court apparently did not even consider this claim. This was error.

In general, §206 of the Investment Advisers Act of 1940 prohibits fraudulent acts by an investment advisor against his client. The language of the statute is roughly parallel to that contained in §10(b) and Rule 10b-5. The acts of Yamada and Engelbach which are discussed in detail above violate specifically all four subparagraphs of §206. In the recent case of Bolger v. Laventhol, Krekstein, Horwath & Horwath, 381 F. Supp. 260 (SDNY 1974), it was held in this district court that a private right of action is maintainable under §206 and that aiders and abettors of an investment advisor's fraud may also be liable. Engelbach is such an aider and abettor. Advest is, therefore, liable. In the Bolger case, in fact, the Investment advisor in question is Akiyoshi Yamada.

POINT V

CERTAIN OF THE TRIAL
COURT'S FACT FINDINGS
WERE CLEARLY ERRONEOUS

Appellant submits that in addition to the incorrect conclusions of law discussed above, the trial court made certain fact findings which were clearly erroneous and should be reversed. The trial court also failed to make certain findings of fact which were clearly warranted from the evidence.

A. The court found that appellant knew or should have known when it received its Fire Fly shares from Advest that a prospectus had not been supplied (364a). This finding has been mentioned above. Clearly, the reverse is true. Since no prospectus was delivered with the confirmation, appellant had no way of knowing that it had purchased a new issue and that a prospectus was required.

B. The court found that Engelbach's first inkling of something wrong came in May 1971 (377a). The same "warnings" about Yamada which the trial court suggests required appellant to "act decisively" (376a) were available to Engelbach long before May 12, 1971.

Engelbach himself testified that as early as February 1971 (well before April when the Fire Fly transaction was made) he was aware of an SEC investigation of Yamada (139a; 192a).

C. The court found that Engelbach had no reason to suspect anything "untoward" in Yamada's actions (376a). Appellant contended at trial and continues to insist that Engelbach not only had reason to suspect Yamada but he knew exactly what Yamada was doing and helped him do it. Engelbach knew (i) that Yamada controlled his selling nominees and the buying fund; (ii) that Yamada was soliciting increased investment moneys from his nominees; that Yamada had guaranteed profits to at least one of his nominees; (iii) that if Yamada could double another nominee's account the individual would invest $100,000 in Takara; (iv) that, therefore, Yamada had a personal self interest in the sellers accounts; (v) that Yamada was violating his fiduciary obligation to the funds; (vi) that if Yamada were crossing the stock for legitimate investment reasons he could easily have caused a direct sale between his nominees and his fund; (vii) that the only

reason Engelbach was being used was to hide from the buyer the fact that Yamada controlled the sellers; (viii) that Engelbach consciously failed to disclose any of the above either to the sellers or to appellant or to his superiors at Advest; (ix) that the Fire Fly stock was a speculative virtually worthless investment; (x) that it was a new issue which required a prospectus be sent; but (xi) that no prospectus was sent to appellant. Appellant insists that it takes a very small inferential step to conclude from all of the above that Engelbach knew that Yamada was using appellant as a dumping ground for the Fire Fly stock which had been issued to his nominees.

D. The court suggested that the sale by appellant of all of its Fire Fly shares could only have depressed the market (377a). This may or may not be true but in either case it is a completely gratuitous comment by the trial court which admits that it did not explore the issue of damages. What is equally true is that the market would have dropped sharply no matter how appellant tried to get rid of its Fire Fly shares. If appellant had tried to sell

its holdings gradually in small lots, the market makers would have known immediately that this very substantial bloc was overhanging the market and the quoted prices would have reacted accordingly.

Perhaps the best evidence that appellant acted responsibly to mitigate its damages is the fact that Engelbach himself sold 1,000 shares for Jacob Blumenthal on May 18, 1971 (the day before appellant sold out its 23,010 shares) for 3 1/2 per share -- exactly the same price appellant got for its large bloc the next day.

E. The court failed to make certain findings which the evidence required. The factual statement of this brief summarizes several crucial facts and makes specific references to the record. Yet the trial court disregarded some of the most material matters. For example there were no findings that:

(i) Yamada breached his fiduciary duty to the appellant by having a personal interest in the sell side of the Fire Fly cross trade.

(ii) Engelbach had knowledge of Yamada's breach of duty to the appellant fund.

(iii) Engelbach too had a personal interest in the success of the Yamada nominees' private accounts.

(iv) Engelbach acted as Yamada's agent for purposes of soliciting funds for Seijo and Takara.

(v) Yamada had made certain performance commitments to his private nominees and Engelbach had knowledge of these commitments.

If these fact findings were made, as they should have been, then it would be impossible to deny that they were material and should have been disclosed to appellant.

CONCLUSION

For all of the reasons set forth herein and on each of the grounds set forth herein, the trial court should be reversed. Judgment should be granted for plaintiff-appellant on all of its claims and the case should be remanded for a determination of damages.

Respectfully submitted,

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Of Counsel:

S. Pitkin Marshall

STATE OF NEW YORK
COUNTY OF NEW YORK

EDWARD TAYLOR being duly sworn deposes and says: On January 7th, 1976 I served the within ~~record on appeal~~ brief ~~appendix~~ on Day, Berry & Howard the attorneys for the Appellee ~~respondent~~ by ~~leaving~~ mailing ~~three~~ two copies thereof at his office located at 1 Constitution Plaza
Hartford Connecticut 06103

Sworn to before me
this 7th day of
January, 1976

Edward Taylor

[illegible]

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